RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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April 9, 1986 LETTER 936

THE PICTURE: In this Letter I discuss the case for deflation in our time. Actually, it's happening now, but will it continue? A later section of this Letter goes into this question. But I can tell you this: almost every newspaper and magazine you pick up today talks about events that are in reality just symptoms of the new deflation. Texas and Oklahoma are in the doldrums as oil prices collapse. Farm land is diving in value. The major broadcasters, the airlines, the steel companies (and everybody else, it seems) are cutting costs and laying off employees. Commodity prices remain in the doldrums, the precious metals refuse to take off, interest rates continue to fall, the various cities and states are scrambling for scarce funds, on and on.

So far, the stock and bond markets love it. But will stocks love it if deflation starts to slow the economy? And will bonds love it if a deflation starts eroding cash flow and bankrupting the marginal outfits? It's all a question of HOW MUCH deflation and how fast. Up to now the markets seem to feel that deflation will be gradual and can be handled -- even bullishly handled. But the question, the big question, is whether deflation will gather momentum. If it does, we'll see a primary bear market -- that's my view.

THE MARKET: As of April 1, the Dow was a whopping 20% ABOVE its 200-day moving average (the MA now stands at 1460). This implied a real strain, and it was one of the reasons I advocated a cessation of stock buying in the last few Letters. But the real key to the intermediate trend of the market, I wrote, was whether the "buying stampede" could continue or whether it would end.

The gauge of the buying stampede is the action of the advance-decline ratio. Any drop of one point or more from its highest peak would mean that the stampede had ended. The high point of the stampede was reached by the A-D ratio on March 27 at minus 5.54 (see page 3 chart). From there the market turned down. On April 4, the A-D ratio, having fallen on four successive days, closed at minus 6.58. This was slightly more than one point loss from the high. Thus, on April 4 the buying stampede terminated.

What does this mean? In my experience, this means that the continuity of the bullish frenzy has ended. Something has snapped. I will go into this further in Late Notes on page 6.

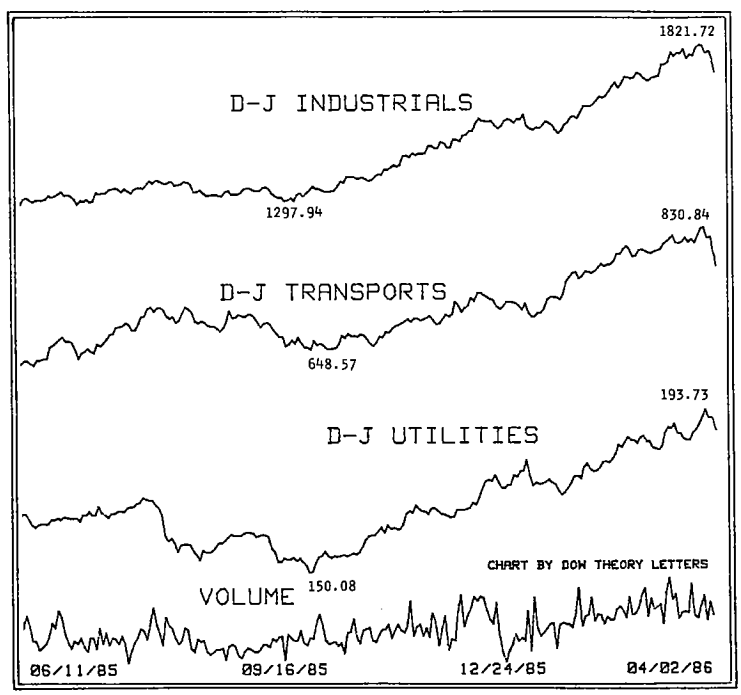
THE FUTURE: Can anyone see the future? The answer, in my opinion, is "no." Even the Bible says it: "It is not given to man to know his fate." But we do have signs, hints, suggestions. We also know that history tends to repeat, and if we have a knowledge of the past we can draw intelligent inferences regarding the future.

Back in the Dec. 26, 1983 issue of Barron's I wrote an article on the rising short interest in the stock market. The article was entitled, "Bearish is Bullish." I ended the article with the two accompanying paragraphs, and in retrospect, the paragraphs proved to be prophetic.

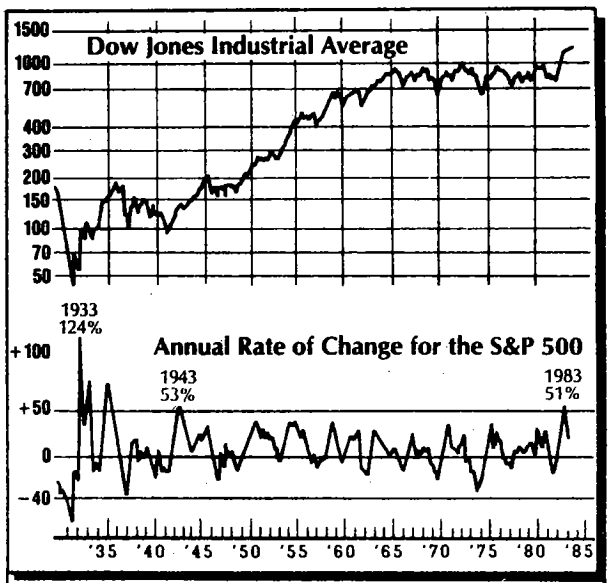
March 27 DJIA 1827.72; PTI 2232; A-D Ratio -5.54
April 4 DJIA 1739.22; PTI 2224; A-D Ratio -6.58

> **What are we to conclude from 1983's extraordinary short interest readings? The obvious answer is that a great pool of speculators—a pool that's been building for a half-year—is betting that the market is crazy and will collapse.**
>
> **What the short sellers refuse to admit is that the market has already discounted the negatives. The basic structure of the long trading range has held intact. Eventually, the sellers and the short sellers will be exhausted, and the balance will finally tip toward the buyers. At that time I expect to see a major rise in the prices of most stocks and a spectacular rout of the bears as the market surges to unexpectedly high levels. All of which will offer dramatic fresh proof that the one thing that shouldn't be sold short is the Dow averages' ability to reflect the true state of the world.■**

In the January 23, 1984 issue of Barron's I wrote a second bullish piece. That piece is included here in its entirety, and I would like my subscribers to study this article carefully Note in the next to last paragraph I wrote that corrective action should carry to "sometime in May-July 1984," and after that (see the last paragraph) "the bull forces should surface with a vengeance."



BARRON'S January 23, 1984



Is Past Prologue?

DOES TECHNICAL history repeat in the stock market? Anyone who has seriously studied Wall Street's action over an extended period knows the answer is yes. And right now, one of the most rewarding cyclical forces could be upon us again: upside momentum.

Few people realize it, but the market's 1982-83 surge was one of the most powerful in history. To document that statement, let's use the very broad Standard & Poor's 500 Stock Average.

By July 1983, this average had climbed 50% above its level a year earlier. Such a rise had occurred only *twice* before in the past half-century—in 1933 and 1943. The story of those advances and their aftermaths may throw light on what we can expect in 1984.

I am indebted to Robert Prechter, who publishes the Elliot Wave Theorist in Gainesville, Ga., for the chart and statistics used on this page. Although the rate-of-change is based on the S&P 500, the D-J Industrial Average is also pictured because the Dow action was based on actual time and because the Dow may be more familiar to the average reader.

Note that the rate-of-change (or momentum) index rose to 124% in 1933. That tremendous surge came one year after the bear market bottom of July 1932 (at which time the Dow had crashed to a low of 41.22). The aftermath of the 1932-33 momentum explosion was a long correction and consolidation. In fact, it took *12 months* before the bull market was ready to take off again. When it finally started up once more, its momentum carried into April 1937.

The second example of a momentum explosion was in May 1943, when the rate-of-change index rose to over 50%. The 1943 instance was less extreme than 1933's and, therefore, I feel it is more comparable to the current situation. In July 1943, the momentum index hit 53%. Subsequently the market corrected, backed and filled for *11 months* before it hit bottom and was ready to spurt ahead again. Following the April 1944 bottom, the stock market marched higher until May 1946.

So where are we today? The momentum index hit a high of just over 50% in July 1983. If technical history repeats, correction and consolidation could take 10 to 12 months. Thus, we might look for an end to the current "sideways, corrective" action sometime in May-July. At which point, the primary bull market should assert itself again.

Remember that momentum surges of 50% or more have, in the past, been associated with major bull markets and that, following those surges, the market has entered long periods of correction and consolidation. I think that is exactly what we have been witnessing since July 1983. But by mid-1984, the corrective action should be over, and the bull forces should surface with a vengeance.

—Richard Russell

Richard Russell publishes Dow Theory Letters.

What happened? My Barron's piece proved to be not only correct but accurate. In July 1984 (following a correction) the market struck a final low with the Dow at 1086.57. From the July low the market began advancing. By the end of 1984, the first buying stampede began, and the market was off on an historic climb. Looking back on both Barron's articles, I would say that they were pretty much on the mark. Russell a prophet? Hardly, I was simply applying a knowledge of markets, market sentiment, momentum and the expected resolution of such phenomena.

"OK Russell," you say, "you did all right back then, but that's all history. What's coming up, that's what we need to know."

Let's take another look at history. After the huge momentum surge of 1933, that bull market advanced (after a 1934 correction) for four more years, finally topping out in April 1937. A vicious crash carried into 1938. From there a series of erratic and frustrating moves finally ended at the World War II low in 1942.

The second example of massive upside momentum occurred in May 1943. Following that great momentum bull signal, the market advanced for three additional years to May 1946. The market smashed in August 1946, and then moved erratically down to a final low in June 1949.

Can the two examples cited here tell us anything about what to expect now? Perhaps, but it is obviously a matter of interpretation. The 1933 momentum surge was followed by another four years of bull market advance. The 1943 momentum surge was followed by three further years of bull market advance.

Now we have the latest huge momentum surge which peaked in July 1983 If we add three years to the 1983 surge we might expect a top (as in the 1940s) around mid- to late-1986. If we add four years to the 1983 surge (as in the 1930s example) we might expect a top in 1987.

Does history repeat? The answer is no, it doesn't or at least it does not have to repeat exactly. My own feeling is that from here on the timing of this bull market becomes progressively more difficult. We are, at this point, asking the age-old bull market question, "How hot is hot?" And nobody, repeat, NOBODY knows the answer to that one.

I would say that from here on subscribers should (1) slow down or halt your buying of stocks, (2) be satisfied with the stocks and bonds you now hold. If you haven't taken a position by now, you're late. Sit it out. The market will always be there, that's the beauty of it. Better to check your greed and miss potential profits than to lose your shirt in a falling or eroding market.

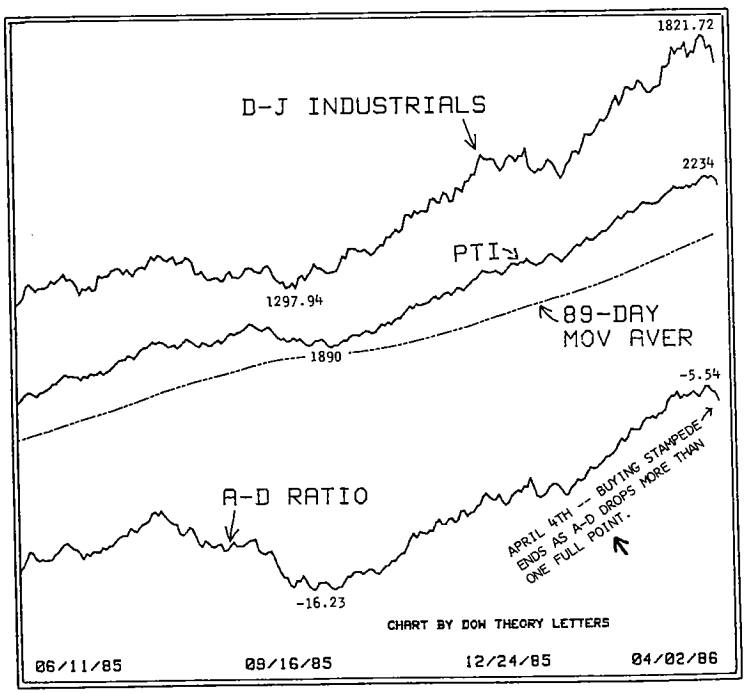
INVESTMENT POSITION: The Dow lost a record 82.50 points on the week ending April 4. More important, the buying stampede ended. Does this mean that the bull market has ended? Not at all, but

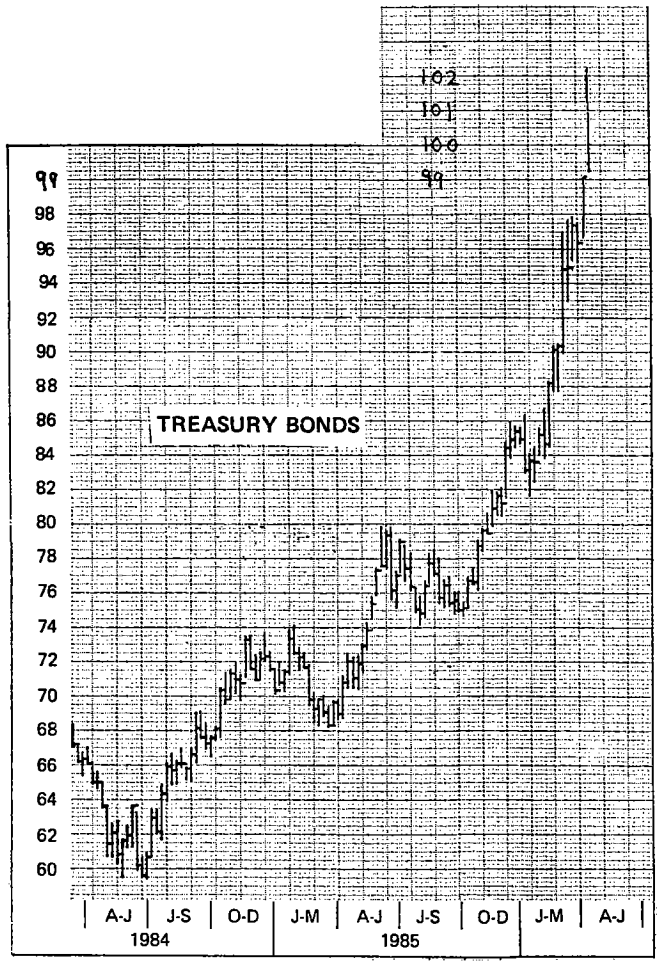
it does mean that the balloon of bull-hysteria has been punctured.

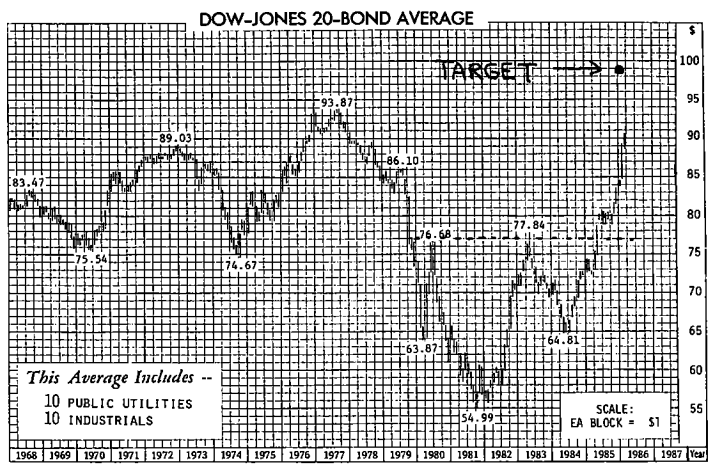
What do we do here? I've suggested that you halt buying in the last two Letters. Now I'm suggesting that we just sit tight and watch the show. "Don't do something, just stand there." Once the bull-hysteria is halted, we should see some corrective action (which is exactly what we saw last week). In fact, it wouldn't be amiss if we see a little fear and loathing creep into Wall Street at this point. After all, it's been "up, up and away" ever since late-1984!

Stocks I'll be watching and waiting to buy on real weakness are Dart & Kraft, Proctor and Gamble, American Home Products, Florida Power, Houston Industries, Nevada Power, JP Morgan, Gannett.

It's a funny thing. When the market is rising you have a big list of stocks you wish you had bought. When the market is dropping, that list tends to dwindle to nothing, and instead you have a list of stocks you wish you had sold. Both wish lists are a waste of time!







BONDS, RATES: In Letter 932 I included a bond section, and I also showed my projection of the Treasury bonds. The method I used was a measurement based on a "head-and-shoulders bottom" pattern. In that piece I projected a value of 100 for the Treasury bond contract, although at the time an advance to 100 for the Treasury contract seemed a bit far-fetched. Last week the 100 target was easily bettered by the Treasury contract (which pushed over 102).

Turning now to the D-J 20 Bond Average, we again see a massive head-and-shoulders bottom. But there we have a situation where the price action has not yet hit the upside target. Measuring from the bottom of the pattern at 54.99 to the neckline (horizontal dotted line) and then measuring the same distance above the dotted line, I get a projection of 99 for the D-J Bond Average. As you can see on the chart, the 20 Bond Average is not there yet, and this suggests that ALL bonds have further to go on the upside.

If the 20Bonds can meet their target at 99, the Bond Average will then have bettered the 93.87 peak of 1977. Such action, if it occurs, would wipe out the entire bear market leg of 1977-'81. At that point (again if it occurs) the bond market would look better than at any time since 1945. And that, in case you didn't notice it, is saying something.

Incidentally, many of you who are not too interested in bonds might consider this comparison. For the first quarter of 1986, the Dow was up 17.5% and the NYSE Composite was up 13.3%. The June T-bond contract from its January low through March 31 was up 27%. In brief, the bond market has been the hot item of 1986, so far.

Question: Russell, I bought bonds a few years ago when you first started urging subscribers to load up with them. I now have big profits, but what do I do with the interest that is coming in?

Answer: This is a question I am asked almost every day. And it's a tough one. Those of us who bought Treasury or muni bonds a few years ago or even last year are staggered by the appreciation in these bonds. But when you were buying AA-rated munis at yields of 9.5% and 10% a year and two years ago, and they are now being offered at yields of 6.8%, what are you supposed to do now?

My answer is that there's nothing wrong with putting your extra cash in money market funds or muni market funds. Sure the regular money market funds only pay a bit over 6% and the muni cash funds pay less than 5%, but let's not be greedy. I remember many years ago when the Treasury magic fives came out (these were long-term T-bonds yielding 5%) everybody thought this was an unbelievably fat rate. "At 5%," said the experts, "money would be drawn from the moon." So I have no objection to putting my current bond income in cash funds and waiting a while.

Question: What about taking profits in the bonds now?

Answer: I've said it a hundred times: primary movements tend to go farther than anybody thinks possible. And we've seen some great recent examples of this truism. Look at the crash in oil, oil having lost two-thirds of its peak value literally in the last six months. Look at the spectacular rise in the stock market (the Dow is up over 17% for the first quarter of 1985). Look at the smash in mid-West farm land, down roughly 30% this year. Look at the slide in commodities, with the CRB Futures Index now at a 7-year low of 208.2 (new low hit on April 3).

Today we're in a big bond bull market. Interest rates on the long Treasuries have fallen almost in half since the 1982 peak. Did anyone suspect this was coming?

And if they did suspect a bull market, did they foresee how far the bonds would rise and how explosive the bond bull market would be? Nobody I know saw the power of the bull market in bonds. We just saw the values, identified the turn and climbed aboard. The bull forces did the rest.

So what I'm saying is that it is very, very difficult to call the top on a major bull market. I'm not going to try. Suffice it to say that I'm still holding 95% of my bonds. You get a move like this maybe two or three times in a lifetime. We might as well play it until it's played out.

FUNDS: Question: Russell, in 1982, 1983 and 1984 you recommended purchase of no-load funds. Then in '85 you stopped and started recommending the strongest Dow stocks. Have you cooled on the funds or what?

Answer: No, I have not cooled on the funds, and for the average investor the no-load (or closed-end) funds are still a good way to participate in a primary bull market. But there are now so MANY funds that you can almost equate the no-load fund market to another stock market. It becomes a question of which fund to buy -- which one out of hundreds.

Question: How about all the services and magazines which deal with the top-rated funds? Doesn't that provide the answer as to what fund to buy?

Answer: All those lists are history. True, if a fund has a management which is good enough to propel that fund to the top of the list, you would think that the given fund would tend to outperform. But it ain't necessarily so. Many funds that are hot one year are cold the next.For instance, Fidelity Select Financial was the top-performing fund over a three-year period ending in 1986. But in 1985, Fid. Sel. Fin. dropped to 25th place (although it still did very well).

So what I'm saying is that last year's top performer may not be this year's top or even good performer. Past performance is no guarantee of future performance, either in stocks or in funds.

Question: Russell, what do you think of the overseas no-load funds? I note that they are performing really well.

Answer: For my answer, see above. It's the same story: the foreign markets did exceptionally well in 1985 -- many of them far outperforming the US markets. So naturally, many overseas funds outperformed the US funds. Fidelity Overseas fund led all the other funds with a 78.6% gain in 1985.

I might note that if the US goes into recession, the world's markets are almost sure to go with it. Many of the foreign stocks and funds have not been tested through a severe secondary reaction or a bear market. Thus, the relative strength of foreign funds may underperform US markets over the next say three to five years.

NOTES & QUOTES: In the last Letter I mentioned sell signals from the Wall Street Week "elves" indicator. Not so, writes the inventor of the indicator, Bob Nurock. I took my information from a Ned Davis chart, but Nurock states that the last Elves sell signal was on June 17, 1983, and that since then there have been buy signals only. I stand corrected, and apologies to Mr. Nurock and WWW.

* *

Ever wonder about the intelligence of the Chinese? Stop wondering. In this year's Westinghouse Science Talent Search in American high schools, the five top scholarship awards ALL (incredibly) went to Asian-Americans, most of them Chinese. Another fact: 20% of all the computer software writers in the US are of Chinese origin.

* *

Statistics: 25% of all the children born in NYC (latest figures) were born to unwed mothers. ... The 1985 statistics show that divorces in the US rose to a 10-year high, up 1.6% from 1984. The biggest increase (for some strange reason) came from Mass., up 16.4%. NY was second, up 11.8%. Biggest decrease was Minn., down 11.7%. Second Michigan, down 10.4%. By the way, for 1985, marriages dropped below the '84 rate, but births were up 1.4%.

* *

Interesting facts: About 85% of all NYC real estate transactions are now in co-ops, and these sales are actually for stock in the buildings (and therefore,

they aren't reported as conventional real estate sales). Despite a recent drop of 11% in NYC real estate values, the city's real estate is still sky-high, even by expensive California standards. For instance, in the San Fernando Valley (northern LA), a recent study shows that the average price for an existing 3-bedroom 1500 square-foot house is $135,000. This is almost exactly the price for a ROOM in Manhattan (a small two-bedroom apartment in NYC, 4½ rooms or less, averaged $387,000 in the last quarter of 1985). Rents in NYC are sky-high. One bedroom apartments rent for $1400 to $1800, and two-bedroom apartments rent for $2000 to $2500 a month. Gotham, anyone?

* *

Baseball is here: What's the only sport in which the team manager dresses in the same uniform as the players? Yes, it's baseball (why this is, I don't know). Baseball is also the only sport in which you can see a grown man in public (often in front of TV) adjusting his pants or spitting wildly in all directions. I like baseball, but I admit it's kind of slow for me (I'm really more of a football fan). Ralph Moyed, columnist for the Wilmington News Journal, wrote last week, " ... to tell the truth about baseball players, they are regarded by sportwriters as the second dumbest bunch of professional athletes, the dumbest being hockey players." They may be dumb, but boy, some of the top salaries. ...

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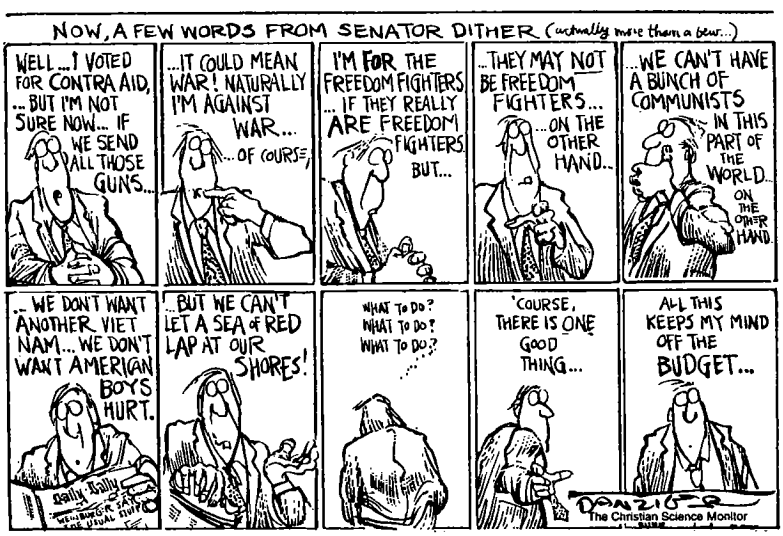
Hope and confusion in Washington. Here's one view of it from the Christian Science Monitor (a great newspaper, by the way).


NOW, A FEW WORDS FROM SENATOR DITHER (actually more than a few...)
WELL... I VOTED FOR CONTRA AID, ...BUT I'M NOT SURE NOW... IF WE SEND ALL THOSE GUNS...
...IT COULD MEAN WAR! NATURALLY I'M AGAINST WAR... ...OF COURSE,
I'M FOR THE FREEDOM FIGHTERS ... IF THEY REALLY ARE FREEDOM FIGHTERS BUT...
...THEY MAY NOT BE FREEDOM FIGHTERS... ...ON THE OTHER HAND...
...WE CAN'T HAVE A BUNCH OF COMMUNISTS IN THIS PART OF THE WORLD... ON THE OTHER HAND
...WE DON'T WANT ANOTHER VIET NAM... WE DON'T WANT AMERICAN BOYS HURT.
...BUT WE CAN'T LET A SEA of RED LAP AT OUR SHORES!
WHAT TO DO? WHAT TO DO? WHAT TO DO?
'COURSE, THERE IS ONE GOOD THING...
ALL THIS KEEPS MY MIND OFF THE BUDGET...
DANZIGER
The Christian Science Monitor

* *

Who's Producing? West Germany is a surprise. With only a quarter of the population of the US, Germany now produces 17% of all the industrial goods in world trade. Japan, with twice the population of W. Germany, produces 16% of the world's industrial exports -- actually less than W.Germany. The US, with a huge population of 240 million people, produces 20% of the world's exported industrial goods, only 3% more than W. Germany. Remember the 1960s talk about the "German miracle." Evidently, it's still happening.

* *

I just read an article in the New York Times that says that almost nobody uses a manual typewriter anymore -- that is except older writers and eccentrics. Well, I guess I must be one or the other, or maybe both. Because I still use an Olympia manual to write these Letters. I could never feel comfortable with an electric typewriter, and word processors drive me up the wall. I like to see what I write as it comes crawling out of my manual in the form of black print on white paper. And I use white-out to get rid of the mistakes, and I use rubber cement to glue together changed sections or paragraphs. So I guess I'm a dinosaur, an insult to the computer generation. The Times article says that only Brother Corp still makes manual typewriters. And they do it for old times sake. Nevertheless, I bet my three Olympias make it to the 21st century. I still love 'em, and they're fool-proof as far as needing repairs are concerned.

* *

Natural history: The test of efficiency is the ability of a species to survive. What is the most efficient mammal? It's the lowly bat: There are 1,000 types of bats, and incredibly of the roughly 4,000 species of mammals on earth, 25% of them are bats! Why bats? Maybe because bats are the only true flying mammals. Bats also occur in the largest mammalian concentrations, with some caves holding over 5 million of the little flyers. ... But considering all creatures, insects are clearly the winners with beatles the big winners within the insect clan (over 40,000 types exist). If all the insects on earth were weighed, they would weigh 12 times as much as all the humans!

* *

THE BOYS: I went to high school (or rather prep school) in NYC. The school was Horace Mann School for Boys, a private school known at the time for its mixture of smart kids, rich kids , poor kids (on scholarship) and good football teams. I graduated in 1942, just as WWII was in full force and just as the tide of the war was beginning to turn in favor of the Allies.

There were a lot of interesting guys in my school, and I mean a lot. Jack Kerouac, founder of the "beat generation," was a class ahead of me. Warren Phillips, now chairman of the board of Dow-Jones, was in my class. And Marvin Davis, the tycoon of Denver, was a class behind me. Famous lawyer Roy Cohen (now being sued by the IRS for $7 million in back taxes) was also a class behind me.

A few weeks ago as I read about Marvin's bid for CBS, I thought back to the chubby guy in high school who was later to make oil and entertainment industry headlines. What, I thought, makes guys like Marvin run? Here's probably the most successful oil wildcatter of this generation, he (brilliantly) sells out his oil interests a few years before the oil bust, and then buys Twentieth Century Fox. He sells his Fox interest and then makes a bid for CBS. Marvin lives in Denver and Beverly Hills. He throws giant star-studded parties, he gives millions to charities, he's a great family man, and he obviously enjoys life (and eating -- Marvin is over 300 pounds).

I guess what makes Marvin Davis tick is the thrill of power, of making headlines, of controlling corporations, of being able to give lavish parties, of having people in restaurants point and say, "Hey,

that's Marvin Davis." And I can understand that, and I can understand why Marvin gets a kick out of it.

And in the hidden recesses of my mind, I ask myself, "Could I have done that? Should I have tried for the big time, the private jets, the million-dollar parties, and the power game?" And I know that I would never have played Marvin's game. I just wasn't interested enough to go for the big gamble and the big leverage and the big play. And if I tried, I probably wouldn't have succeeded.

Instead I spent a lot of time attempting to get my own head straight. And, of course, I wasn't willing to take the big chances that I know Marvin Davis had to take.

But I'm glad Marvin made it in his world. Because what he does makes exciting reading, and it makes for excitement on Wall Street and excitement in the corporate world. If it weren't for guys like Davis, the world would be a much duller place. Look at Russia. All the Russians can do for excitement is wonder what Gorbachev will do next, if indeed, he does anything. No, I'll take the world of Boone Pickens, Lawrence Tisch or Marvin Davis any day. More power to you, Marvin, you make the market pop, and I'll write about it.

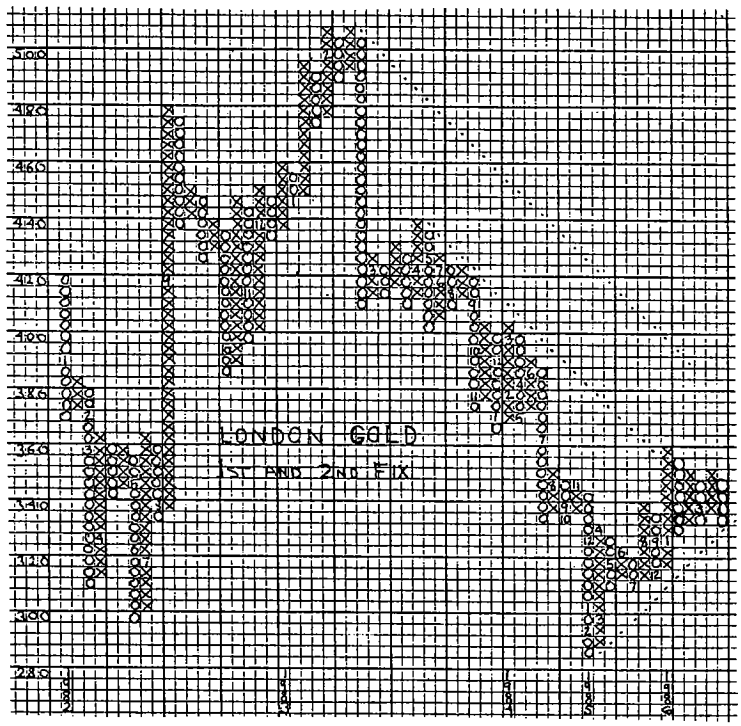
GOLD: I know that I have a great many gold-oriented subscribers. I know this from letters I receive, and I know it because literally hundreds of my subscribers show up at the big hard-money conferences.

Recently, I suggested coin averaging for gold-philes, and by this I mean buying one or 10 or 20 gold coins each month. In other words, build up a collection of gold coins over an extended period of time. I suggested this policy not as a big money maker (stocks and bonds have been the moneymakers) but as a way to build an "insurance policy" in real money -- gold.

Gold hit a bear market low of 284.25 (London fix) in February 1985. It hasn't broken that low since. I have felt that the 284.25 low would hold. If that was indeed THE low for the bear market, then by definition a bull market in gold started in early 1985. Nobody can tell a bull market how to act, how to advance, or how to hide its forces of slow accumulation.

My most basic gold chart is my point & figure chart of London gold. I am including that chart here. On a cold analysis, if the London fix drops to 328 gold will have given a double bearish signal in that (1) it will have dropped below two declining rows of zeros, and (2) it will have dropped below the rising trendline (dotted trendline drawn from the low). If that happens, the next significant support level is 312. I would not want to see 312 broken.

Last week a discouraging statistic for gold-philes appeared. It was the gold relative strength index (gold divided by the NYSE Composite). This ratio dropped on April 1 to a new post-1980 low of 245. In other words, gold compared to a broad list of NYSE stocks sank to a new relative strength low. In the past, when this index was in a downtrend (which it now is) the background has been negative for



precious metals. With it all, however, gold does continue to hold above its critical lows of 328, 312 and 284.

LATE NOTES: Investment Quality Trends of La Jolla, which keeps careful records of 350 blue-chip stocks, notes in its latest issue that only 19% of these stocks are now "undervalued." This is getting into the danger zone. Best values at this time are the utilities, many of which still offer attractive yields.

But when the markets get overvalued and the public becomes over-zealous, Wall Street has a way of cooling the love affair. It's called correction time, and it may be that we are there. It's not for sure -- but it just may be. My PTI, still far above its moving average (page 3 chart), has a way of coming down and kissing its moving average at least twice a year (during bull markets), and we could be in that process now.

As for the bonds, they're certainly due for a cool-off period. The Treasury bonds are now totally out of whack with the munis. Long-term T-bonds yield 7.6% while AA-rated California state general obligation bonds yield 6.9%. The high-grade tax-free munis now yield 90.7% as much as the Treasury obligations! The normal ratio is nearer 80%. Thus, anyone in the Golden State who buys T-bonds over state GOs must know something I don't know. Is California going to slip into the ocean? Naaah.

The beauty of the markets is that they are subject (as are you and I) to the laws of nature. When you and I party it up with say a big Reubens special and three martinis, we spend the next day or so holding our stomach with one hand and our head with the other. The markets do the same thing -- at which point we hold our pocketbooks and our breaths.

After a boom comes a correction (i.e., the bond market, the stock market). After a smash comes a rebound (i.e., the dollar, oil). After very little evidently comes more very little (i.e., gold). And with erosion comes more erosion (i.e., the commodities).